
HYBRID INSTRUMENTS

Hybrid capital instruments have characteristics of both common stock and unsecured debt. They resemble debt because they generally pay a fixed or floating interest rate, coupon, or dividend. At the same time, these securities are deeply subordinated, often have long maturities, and may be similar to common equity in their ability to absorb losses. Banking organizations in the United States rely on hybrid capital instruments and other innovative instruments for capital funding. Sources of hybrid capital funding are continually evolving. These sources of funding, especially if double leveraged,¹ can increase an institution's risk profile by generating substantial pressure to maintain earnings to support dividend payments. An institution's over-reliance on double leverage will trigger increased supervisory scrutiny.

Advantages to issuers for considering hybrid instruments include a lower cost of capital, tax deductibility, regulatory and rating agency equity credit recognition, and diversity in funding source. However, the overuse of hybrid instruments could lead to increased levels of risk that warrant management's close attention. Risks may include increased leverage, a thinner capital base for the consolidated organization (including both the savings association and its holding company), increased interest rate risk, and increased funding and liquidity risks.

During the thrift and holding company examinations, as well as through ongoing supervisory monitoring, OTS will review capital levels and the ability to service debt both individually and on a consolidated basis. While hybrid capital instruments can help banking organizations manage their capital structure, OTS expects parent-infused Tier 1 capital to derive predominantly from voting common stock or retained earnings of its parent. In addition, OTS considers the following features as guiding principles when evaluating hybrid instruments: loss absorption ability, permanence of the instrument, ability to suspend dividend payments, and certainty in cost of funding.

Some of the more familiar types of hybrid capital instruments include trust preferred securities (TPS) and asset-driven securities, particularly real estate investment trust (REIT) preferred securities. There are also innovative hybrid instruments such as mandatory convertible preferred securities and enhanced trust preferred securities that have resulted from regulatory and rating agency changes.

Trust Preferred Securities

Trust preferred securities are non-perpetual cumulative preferred securities. In most cases, the holding company establishes a special purpose entity (SPE), usually in the form of a trust, to issue the securities. The SPE issues preferred securities to outside investors. With the proceeds, the SPE purchases an equivalent amount of junior subordinated debentures with stated maturities from the holding company. The subordinated note, which is senior only to a holding company's common and preferred stock, has terms that generally mirror those of trust preferred securities, except that the subordinated note often has a fixed maturity of at least 30 years.

Generally, the terms of the trust preferred securities allow the trust to defer dividends for at least a twenty-consecutive-quarter period without creating an event of default or acceleration. If the trust fails to pay the

¹ For a source of capital, savings associations sometimes rely on debt the holding company issues. Double leverage exists when a holding company invests funds it obtains from debt proceeds into the savings association as equity. Increasing the capital base allows the savings association to increase its borrowings as well, thereby compounding the original holding company debt resulting in higher consolidated leverage.

cumulative dividend after this period, default occurs, and the principal and interest on the note becomes immediately due and payable. Dividends paid on trust preferred securities are a tax deductible interest expense thus representing a key advantage for holding companies.

Pooled issuances of trust preferred securities typically involve thirty or more separate holding company issuers and have made the issuance of trust preferred securities possible for small holding companies, most of which did not previously have this form of capital market access.

Real Estate Investment Trust (REIT) Preferred Securities

Subordinate organizations of the savings association often issue REIT preferred securities. A thrift-controlled REIT issues noncumulative perpetual preferred securities into the market and uses the proceeds to buy mortgages and mortgage-backed securities from its majority common shareholder, its parent institution. A SPE must qualify under federal tax laws to be a REIT. The two main qualifications for a REIT are that it must (a) hold predominantly real estate assets and (b) annually pay out a substantial portion of its income to investors. The benefit of qualifying as a REIT is that its income is not subject to an entity-level tax. Rather, taxation occurs at the investor level.

In a typical structure where the thrift controls a REIT, the REIT subsidiary preferred securities, in general, could qualify for inclusion in Tier 1 capital as minority interests in a consolidated subsidiary subject to certain prudential standards. The terms and conditions include but are not limited to a capital limitation and a convertibility provision. Preferred securities may constitute no more than 25 percent of a savings association's Tier 1 capital. In addition, the convertibility provision allows the thrift to exchange noncumulative REIT preferred securities directly for issued noncumulative perpetual preferred securities of the parent institution upon the occurrence of certain events, such as the institution becoming undercapitalized, going into receivership, or at the direction of the regulator.

Enhanced Trust Preferred Securities

Enhanced trust preferred securities have more equity characteristics than traditional trust preferred securities and receive equity credit from credit-rating agencies. Revised rating agency guidelines that allow partial equity credit treatment of these securities has driven the growth of enhanced trust preferred securities. Enhanced trust preferred securities differ from traditional trust preferred securities in several ways:

- A longer maturity of 60-80 years versus 30 years;
- A longer deferral period of ten years versus five years;
- Inclusion of replacement capital covenant (similar hybrid security needs to be issued to replace an existing hybrid in the event of redemption); and
- Alternative payment mechanism (permits issuer to settle omitted coupon payments in cash via the market issuance of securities, or by giving the hybrid holder equity-like securities).

Mandatory convertible preferred securities

Mandatory convertible preferred securities involve the joint issuance by a holding company to investors of trust preferred securities and a forward purchase contract. The forward contract obligates the investors to purchase a fixed amount of the holding company's common stock, generally in three to five years.